

Before the  
Federal Communications Commission  
Washington, D.C. 20554

In the Matter of	)	
	)	
Multi-Association Group (MAG) Plan for	)	CC Docket No. <u>00-256</u>
Regulation of Interstate Services of Non-Price	)	
Cap Incumbent Local Exchange Carriers and	)	
Interexchange Carriers	)	
	)	
Federal-State Joint Board on Universal	)	CC Docket No. 96-45
Service	)	
	)	

**REPORT AND ORDER AND  
SECOND FURTHER NOTICE OF PROPOSED RULEMAKING**

Adopted: February 12, 2004

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**Comment Date: 30 days from publication in the Federal Register**

**Reply Comment Date: 45 days from publication in the Federal Register**

By the Commission: Commissioners Copps and Adelstein issuing separate statements.

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1. Today, we take additional steps to provide rate-of-return carriers greater flexibility to respond to changing marketplace conditions. In the *MAG Order and Further Notice*, the Commission reformed interstate access charges and universal service and sought comment on various other issues affecting rate-of-return carriers.<sup>1</sup> In this order, we resolve several issues on which the Commission sought comment in the *MAG Further Notice*.<sup>2</sup> In particular, we modify the “all-or-nothing” rule to permit rate-of-return carriers to bring recently acquired price cap lines back to rate-of-return regulation. In this way, we reduce the administrative costs and uncertainties of such acquisitions for rate-of-return carriers. We also grant rate-of-return carriers the authority immediately to provide geographically deaveraged transport and special access rates, subject to certain limitations. With this additional pricing flexibility, rate-of-return carriers will be able to set more economically efficient rates and respond to competitive entry. Finally, we merge Long Term Support (LTS) with Interstate

<sup>1</sup> *Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers*, CC Docket No. 00-256, *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, *Access Charge Reform for Incumbent Local Exchange Carriers Subject to Rate-of-Return Regulation*, CC Docket No. 98-77, *Prescribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers*, CC Docket No. 98-166, Second Report and Order and Further Notice of Proposed Rulemaking in CC Docket No. 00-256, Fifteenth Report and Order in CC Docket No. 96-45, and Report and Order in CC Docket Nos. 98-77 and 98-166, 16 FCC Rcd 19613 (2001) (*MAG Order or MAG Further Notice*, as appropriate) [subsequent history omitted]. We defer to a later order consideration of the outstanding petitions for reconsideration of the *MAG Order*.

<sup>2</sup> Appendix B lists the parties filing comments and replies on the *MAG Further Notice*, as well as the shortened name used for each party.

Common Line Support (ICLS). This will make the universal service mechanisms simpler and more transparent, while ensuring that rate-of-return carriers maintain existing levels of universal service support.

2. We also initiate a further notice of proposed rulemaking seeking comment on two specific plans that propose establishing optional alternative regulation mechanisms for rate-of-return carriers. In conjunction with the consideration of those alternative regulation proposals, we also seek comment on modifications that would permit a rate-of-return carrier to adopt an alternative regulation plan for some study areas, while retaining rate-of-return regulation for other of its study areas. Consideration of these industry proposals furthers our commitment to investigating alternative regulatory methods that could benefit both rate-of-return carriers and their customers.

## II. BACKGROUND

### A. MAG Order

3. In implementing the provisions of the Telecommunications Act of 1996 (1996 Act),<sup>3</sup> the Commission consistently has taken into consideration the differences between price cap and rate-of-return carriers, as well as the wide diversity among rate-of-return carriers. Thus, in 1997, when the Commission adopted interstate access charge reforms for price cap carriers, it recognized the need for more comprehensive review of the issues and circumstances specific to rate-of-return carriers.<sup>4</sup> In 1998, the Commission created a separate docket to undertake such review.<sup>5</sup> While it proposed reforms similar to those adopted for price cap carriers, the Commission recognized that differences between the two groups might warrant a different approach in some matters, including a different transition to more efficient, cost-based rates.

4. In October 2000, four incumbent local exchange carrier (LEC) associations submitted the Multi-Association Group (MAG) plan, a proposal addressing numerous issues facing rate-of-return carriers, including access charge reform and universal service support.<sup>6</sup> After extensive comment,<sup>7</sup> the Commission released the *MAG Order* on November 8, 2001,

<sup>3</sup> Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996) (1996 Act). The 1996 Act amended the Communications Act of 1934 (Act). 47 U.S.C. §§ 151 *et seq.*

<sup>4</sup> See *Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing, End User Common Line Charges*, CC Docket Nos. 96-262, 94-1, 91-213, 95-72, First Report and Order, 12 FCC Rcd 15982, 16126-27, paras. 330-332 (1997) (*Access Charge Reform Order*) (subsequent history omitted).

<sup>5</sup> See *Access Charge Reform for Incumbent Local Exchange Carriers Subject to Rate-of-Return Regulation*, CC Docket No. 98-77, Notice of Proposed Rulemaking, 13 FCC Rcd 14238, 14240, paras. 3-4 (1998) (*1998 Notice*).

<sup>6</sup> Petition for Rulemaking of the LEC Multi-Association Group, RM No. 10011, filed Oct. 20, 2000.

<sup>7</sup> In January 2001, the Commission requested comment on whether it should adopt the MAG plan as an integrated package, as requested by the MAG, or adopt specific aspects of the plan. *Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers*, CC Docket No. 00-256, *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, *Access Charge Reform for Incumbent Local Exchange Carriers Subject to Rate-of-Return Regulation*, CC Docket No. 98- (continued....)

which modified the Commission's rules to reform the interstate access charge and universal service support system for incumbent local exchange carriers subject to rate-of-return regulation. Specifically, the *MAG Order* sought to foster efficient competition and efficient pricing in the market for access services by rationalizing the access rate structure and driving per-minute rates towards lower, more cost-based levels, while furthering universal service goals.<sup>8</sup> The Commission aligned the interstate access rate structure more closely with the manner in which costs are incurred, and created a new universal service support mechanism, Interstate Common Line Support, to replace the implicit support in interstate access charges with explicit support that is portable to all eligible telecommunications carriers (ETCs).<sup>9</sup> ICLS ensures that rate-of-return carriers will recover their common line revenue requirements, including their authorized rate of return, while continuing to provide their customers with quality, affordable service.<sup>10</sup>

## B. Further Notice of Proposed Rulemaking

5. In the Further Notice of Proposed Rulemaking, attached to the *MAG Order*, the Commission solicited further comment on the incentive plan proposed by rate-of-return carriers and how it might be modified to provide incentives for cost efficiency gains by rate-of-return carriers that would benefit consumers through lower interstate rates and improved services. The Commission also requested comment on additional pricing flexibility measures for rate-of-return carriers and on the MAG's proposed changes to the Commission's "all-or-nothing rule." It also solicited comment on merging the LTS Mechanism into ICLS.

(Continued from previous page)

77, *Prescribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers*, CC Docket No. 98-166, Notice of Proposed Rulemaking, 16 FCC Rcd 460, 461, para. 3 (2001) (*MAG Notice*).

<sup>8</sup> See *MAG Order*, 16 FCC Rcd at 19616, para. 1.

<sup>9</sup> See *id.* at 19617, para. 3.

<sup>10</sup> In implementing these general goals, the Commission took the following specific steps. It: (1) adopted the MAG proposal to increase the Subscriber Line Charge (SLC) caps for rate-of-return carriers to the levels established for price cap carriers; (2) modified the Commission's rules to allow SLC deaveraging; (3) set the inefficient Carrier Common Line Charge (CCL) for phase-out as of July 1, 2003, when SLC caps are scheduled to reach their maximum levels; (4) shifted the non-traffic sensitive costs of local switch line ports to the common line category, and reallocated the remaining costs contained in the Transport Interconnection Charge (TIC) among all the access categories; (5) declined to prescribe a single, target rate for per-minute charges; (6) created ICLS to convert implicit support in the access rate structure to explicit support that is available to all ETCs; (7) rejected MAG proposals to impose new requirements on interexchange carriers regarding optional calling plans, minimum monthly fees, and pass-through of savings from lower access rates; (8) streamlined the rules for the introduction of new switched access services by extending to rate-of-return carriers rules similar to those governing price cap carriers; and (9) terminated the pending proceeding for prescription of the authorized rate-of-return, which was set at 11.25 percent in 1990. A detailed background on interstate access charges, universal service and rate-of-return regulation is set forth in the *MAG Order*. *MAG Order*, 16 FCC Rcd at 19622-30, paras. 16-32.

### III. REPORT AND ORDER ON FURTHER NOTICE OF PROPOSED RULEMAKING

#### A. All-or-Nothing Rule

##### 1. Background

6. Section 61.41 of the Commission's rules provides that if a price cap carrier is in a merger, acquisition, or similar transaction, it must continue to operate under price cap regulation after the transaction.<sup>11</sup> In addition, when rate-of-return and price cap carriers merge or acquire one another, the rate-of-return carrier must convert to price cap regulation within one year.<sup>12</sup> Furthermore, if an individual rate-of-return carrier or study area converts to price cap regulation, all of its affiliates or study areas must also convert to price cap regulation, except for its average schedule affiliates.<sup>13</sup> Finally, LECs that become subject to price cap regulation are not permitted to withdraw from such regulation or participate in NECA tariffs.<sup>14</sup> These regulatory requirements collectively are referred to as the all-or-nothing rule, and were affirmed by the United States Court of Appeals for the D.C. Circuit.<sup>15</sup>

7. The all-or-nothing rule addresses two concerns about mergers and acquisitions involving price cap companies.<sup>16</sup> First, a LEC could attempt to "game the system" by switching back and forth between rate-of-return regulation and price cap regulation.<sup>17</sup> A price cap carrier could increase earnings by opting out of price cap regulation, building a larger rate base under rate-of-return regulation in order to raise rates, and then, after returning to price cap regulation, cutting costs back to an efficient level. The Commission reasoned that it would not serve the public interest to allow a carrier to "fatten up" under rate-of-return regulation and "slim down" under price cap regulation, because rates would not decrease in the manner intended under price cap regulation.<sup>18</sup> The second concern motivating the all-or-nothing rule is that a LEC with affiliates under both forms of regulation could attempt to shift costs from its price cap affiliate to

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<sup>11</sup> 47 C.F.R. § 61.41(c)(1).

<sup>12</sup> 47 C.F.R. § 61.41(c)(2).

<sup>13</sup> 47 C.F.R. §§ 61.41(b), 69.605 ("[a] telephone company that was participating in average schedule settlements on December 1, 1982, shall be deemed to be an average schedule company except that any company that does not join association tariffs for all access elements shall not be deemed to be an average schedule company.").

<sup>14</sup> 47 C.F.R. §§ 61.41(d), 61.41(a)(3).

<sup>15</sup> See *National Rural Telecom Assoc. v. FCC*, 988 F.2d 174 (D.C.Cir. 1993).

<sup>16</sup> See *Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313, Order on Reconsideration, 6 FCC Rcd 2637, 2706, para. 148 (1991) (*LEC Price Cap Reconsideration Order*); see also *ALLTEL Corporation Petition for Waiver of Section 61.41 of the Commission's Rules and Applications for Transfer of Control*, Memorandum Opinion and Order, 14 FCC Rcd 14191, 14199, para. 18 (1999) (*ALLTEL Order*).

<sup>17</sup> See *LEC Price Cap Reconsideration Order*, 6 FCC Rcd at 2706, para. 148.

<sup>18</sup> *Id.*

its rate-of-return affiliate.<sup>19</sup> This would allow the rate-of-return affiliate to charge higher rates than otherwise possible to recover its higher revenue requirement (because of the increased costs), while at the same time, increasing profits of the price cap affiliate as a result of its cost savings.<sup>20</sup> Despite these concerns, however, the Commission has waived the all-or-nothing rule where it has found that petitioners have established good cause and that waiver will serve the public interest.<sup>21</sup>

8. In the *MAG Further Notice*, the Commission deferred action on any reforms, including those proposed by the MAG, of the all-or-nothing rule, while seeking additional comment on the rule and on issues concerning incentive regulation and pricing flexibility.<sup>22</sup> We sought comment generally on whether our regulatory policy, of preventing affiliated carriers from operating under different systems of regulation, is still serving the public interest; on what circumstances and conditions that prompted these rules in the past may have changed; and on why these rules should be retained, repealed or modified.<sup>23</sup> Specifically, we asked whether customers would be better off, and competition better served, with or without the rules.<sup>24</sup> We sought comment on the extent to which an increasingly competitive environment should affect any decision to retain or eliminate the rules.<sup>25</sup> We also sought comment on whether the all-or-nothing restrictions currently are necessary to prevent cost shifting and gaming.<sup>26</sup> Specifically, we asked whether the protection the rule provides against cost shifting and gaming is outweighed by regulatory efficiency gains that could result from eliminating the all-or-nothing requirements.<sup>27</sup> We sought comment on the extent to which alternative accounting and reporting

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<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> The Commission has granted waivers in cases where rate-of-return carriers have acquired price cap exchanges and a price cap company, thus permitting them to continue operating under rate-of-return regulation rather than requiring them to convert to price caps. In these instances, the Commission concluded that concerns about cost shifting and gaming were not at issue. See, e.g., *ATEAC, Inc., Alaska Tel. Co., Arctic Slope Tel. Assoc. Coop., Inc., Interior Tel. Co., Inc., Mukluk Tel. Co., Inc., and United-KUK, Inc. Petitions for Waiver of Sections 61.41(c) and (d) of the Commission's Rules*, CCB/CPD No. 00-03, Memorandum Opinion and Order, 15 FCC Rcd 23511, 23518 para. 14 (2000); *Minburn Telecom., Inc. Petition for Waiver of Sections 61.41(c) and (d) of the Commission's Rules*, CCB/CPD No. 99-16, Memorandum Opinion and Order, 14 FCC Rcd 14184, 14188, para. 8 (1999); *ALLTEL Corp. Petition for Waiver of Section 61.41 of the Commission's Rules and Applications for Transfer of Control*, CCB/CPD 99-1, Memorandum and Order, 14 FCC Rcd 14191, 14201-02 para. 27-28 (1999) (*ALLTEL Order*) (finding of special circumstances based on service to diverse areas in 22 states with varied market conditions, thus making the application of a single productivity factor under price cap regulation unsuitable for ALLTEL's entire operation).

<sup>22</sup> See *MAG Further Notice*, 16 FCC Rcd at 19720 para. 265.

<sup>23</sup> *Id.* at 19720 para. 266.

<sup>24</sup> *Id.* at 19720-21 para. 267.

<sup>25</sup> *Id.*

<sup>26</sup> *Id.* at 19722-24 para. 270.

<sup>27</sup> *Id.*

rules could substantially reduce cost shifting concerns.<sup>28</sup> We further asked whether it would be reasonable to impose more stringent reporting requirements on carriers that seek waivers of the all-or-nothing requirements.<sup>29</sup>

9. Supporting the elimination of the all-or-nothing rule, rate-of-return LECs argue that the rule discourages LEC competition, innovation and expansion by complicating transactions between carriers.<sup>30</sup> They also argue that sufficient safeguards are in place to protect against the abuses envisioned by the rule,<sup>31</sup> and allege that there is no evidence of cost-shifting abuses in the record.<sup>32</sup> Commenters also argue that the rule is routinely waived.<sup>33</sup> NTCA and ICORE specifically advocate elimination of the rule for all rate-of-return carriers that seek to keep all of their study areas under rate-of-return regulation.<sup>34</sup> On the other hand, major IXC, the CUSC and the General Services Administration (GSA) support retention of the all-or-nothing rule, arguing that the same incentives for LECs to shift costs exist today as when the rule was adopted<sup>35</sup> and that existing safeguards are insufficient to detect cost shifting,<sup>36</sup> especially since accounting requirements are increasingly relaxed.<sup>37</sup>

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<sup>28</sup> *Id.*

<sup>29</sup> *Id.*

<sup>30</sup> ITTA Comments at 2-3; ICORE Comments at 14-15.

<sup>31</sup> The commenters argue that the following safeguards are sufficient to eliminate the all-or-nothing rule: *tariff processes* (ITTA Comments at 5, Verizon Comments at 5, PRTC Comments at 11, ALLTEL Comments at 31-32), *accounting and cost allocation rules* (Verizon Comments at 5, PRTC Comments at 10, NRTA Comments at 11-12, ALLTEL Comments at 31, ICORE Comments at 15, Valor Reply Comments at 5), *affiliate transaction rules* (PRTC Comments at 10, NRTA Comments at 11-12, ALLTEL Comments at 30-31), *jurisdictional separations rules* (Verizon Comments at 5, PRTC Comments at 10, ALLTEL Comments at 30-31), *reporting requirements* (Verizon Comments at 5, PRTC Comments at 10-11, NRTA Comments at 11-12), *nonstructural mechanisms including complaint processes* (NRTA Comments at 11-12, Valor Reply Comments at 5) and *state regulators* (NRTA Comments at 11-12, ALLTEL Comments at 31-32).

<sup>32</sup> NRTA Comments at 10-11, Valor Reply Comments at 4. Valor contends that carriers receiving a waiver so far have not misbehaved. Valor Reply Comments at 4.

<sup>33</sup> PRTC Comments at 10, NRTA Comments at 9-10. ALLTEL adds that, as price cap LECs seek to divest themselves of small exchanges, waiver requests will increase even more. ALLTEL Comments at 28-29.

<sup>34</sup> NTCA Comments at 7-8; ICORE Comments at 13-15.

<sup>35</sup> AT&T Comments at 16.

<sup>36</sup> *Id.* at 17, GSA Comments at 8. AT&T argues that because separations and tariff submissions are not based on independent audits, but rather on LEC reporting, they are an insufficient guard against abuses. AT&T Reply Comments at 14. AT&T further argues that detection of cost-shifting abuses through examination of LEC tariff filings is necessarily delayed because LECs make those filings only on a biannual basis. AT&T Reply Comments at 14.

<sup>37</sup> WorldCom Comments at 4.

## 2. Discussion

10. We modify the all-or-nothing rule to permit a limited exception, as proposed by NTCA and ICORE,<sup>38</sup> when a rate-of-return carrier acquires lines from a price cap carrier and elects to bring the acquired lines into rate-of-return regulation.<sup>39</sup> The rule, as amended, will permit the acquiring carrier to convert the price cap lines back to rate-of-return regulation. We defer further action on the all-or-nothing rule until we have reviewed the record compiled in response to the further notice that we also issue today.<sup>40</sup>

11. The current record of this proceeding is insufficient for us to decide today on whether or how to adopt additional reforms of the all-or-nothing rule. The parties supporting the rule typically assert, without specific examples, that relaxation of the rule will result in cost-shifting, which other safeguards will be unable to detect.<sup>41</sup> On the other hand, rate-of-return carriers assert that the rule raises transaction costs, and they argue that the rule is unnecessary because other, existing safeguards are capable of detecting the cost-shifting at which the rule is aimed.<sup>42</sup> In light of the relatively uninformative record on these issues, we largely defer action on the all-or-nothing rule until we have reviewed the additional comments on this issue that we solicit today in our further notice. To provide immediate relief to rate-of-return carriers, however, we think it appropriate at this time to create a limited exception to the all-or-nothing rule.

12. As we note above, the Commission adopted the all-or-nothing rule in order to avoid two specific problems that it envisioned. First, the Commission sought to prevent a carrier from shifting costs from its price cap affiliate to its rate-of-return affiliate, recovering those costs through the higher, cost-based rates of the non-price cap affiliate and increasing the profits of the price cap affiliate because of its reduced costs. Second, the Commission intended to prevent carriers from gaming the system by switching back and forth between the two different regulatory regimes. At a minimum, the record currently supports reform of our all-or-nothing

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<sup>38</sup> NTCA Comments at 7-8; ICORE Comments at 13-15.

<sup>39</sup> In the alternative, and until such time as the all-or-nothing rule may be further revised, carriers can continue to petition for waiver of the all-or-nothing rule so that they may operate affiliates under both rate-of-return and price cap regulation.

<sup>40</sup> Additionally, all outstanding interim waivers of the all-or-nothing rule that depend on our decision in this proceeding shall continue in effect until we issue a final order on this issue. See, e.g., *Valor Telecommunications, LLC Petition for Waiver of Section 61.41 of the Commission's Rules*, Memorandum Opinion and Order, 17 FCC Rcd 25544 (2002); *ALLTEL Corporation Petition for Waiver of Section 61.41*, *ALLTEL Corporation Petition to Extend Interim Waiver of Section 61.41 of the Commission's Rules*, *CenturyTel, Inc. and CenturyTel of Alabama, LLC Petition for Waiver of Sections 61.41(b) and (c) of the Commission's Rules*, *CenturyTel, Inc. and CenturyTel of Missouri, LLC Petition for Waiver of Sections 61.41(b) and (c) of the Commission's Rules*, *Puerto Rico Telephone Company Petition for Waiver of Section 61.41 of the Commission's Rules* or, in the Alternative, *Request for Waiver of Section 54.303(a) of the Commission's Rules*, Memorandum Opinion and Order, 17 FCC Rcd 27694 (2002).

<sup>41</sup> See *supra* note 35 and accompanying text.

<sup>42</sup> See *supra* notes 30-31 and accompanying text.



rule when a rate-of-return carrier acquires price cap lines but intends to operate all of its lines, including the newly acquired price cap lines, under rate-of-return regulation.

13. When a rate-of-return carrier seeks to return acquired price cap lines to rate-of-return regulation, the problems that the all-or-nothing rule sought to prevent do not exist, or can be addressed in a less burdensome way. Because the carrier wishes to have all of its lines be subject to rate-of-return regulation, there can be no danger of cost shifting between price cap and non-price cap affiliates. Similarly, a rate-of-return carrier in this position is not necessarily seeking to game the system by moving back and forth between different regulatory regimes. However, recognizing the possibility that the acquiring rate-of-return carrier could later seek to return to price cap regulation, thereby potentially gaming the system, we conclude that once a rate-of-return carrier brings acquired price cap lines into rate-of-return regulation, it may not for five years elect price cap regulation for itself, or by any means cause the acquired lines to become subject to price cap regulation, without first obtaining a waiver. We believe that this restriction responds to the concerns underlying the adoption of the all-or-nothing rule, consistent with our policy goals in administering the two separate systems of rate regulation, while not requiring that the election be unnecessarily irreversible, as proposed by commenters.<sup>43</sup> We do not restrict the number of lines that may be acquired by a rate-of-return carrier and returned to rate-of-return regulation because the risks of abuse are very small and the administrative benefits are significant. We have granted waivers of the all-or-nothing rule involving as many as 285,000 lines<sup>44</sup> with no discernible adverse effects with respect to the consequences that the all-or-nothing rule was designed to preclude, and no significant impact on the Commission's universal service programs.<sup>45</sup> We believe that most acquisitions of price cap lines by rate-of-return carriers will not exceed this level, and thus find no reason to believe that any adverse effects will result in the future. It is also important to note, however, that but for the limited exception we create above, we do not otherwise modify rule 61.41(d), which provides that once a carrier is subject to price cap regulation, it may not subsequently return to rate-of-return regulation.

14. We note that several commenters representing small and mid-sized incumbent LECs advocate reform of the all-or-nothing rule, citing the additional transaction costs and uncertainty that the rule creates for small, typically rural, carriers that seek to acquire lines from

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<sup>43</sup> See Verizon Comments at 5 (proposing acquired carrier's election to rate-of-return regulation be irreversible, barring waiver for good cause shown); cf. Valor Comments at 7-8 ("a limited ability to change regulatory mechanisms is necessary to ensure that future investment in rural infrastructure and deployment of advanced services for rural communities is not unduly impeded").

<sup>44</sup> See *ALLTEL Order*, 14 FCC Rcd at 14192, para. 2.

<sup>45</sup> The acquired lines will be included by the acquiring rate-of-return carrier in calculating its common line revenue requirement, and the rate-of-return carrier will thus be eligible to receive ICLS. 47 C.F.R. § 54.902. Although this may increase universal service support through the ICLS mechanism, our experience reviewing requests for study area waivers indicates that the migration of lines is unlikely to significantly increase universal service funding. We note that, in most cases, parties transferring lines from a price cap carrier to a rate-of-return carrier will still be required to demonstrate a minimal impact on universal service in order to obtain the necessary study area waiver. A study area waiver would not be required if a price cap carrier transferred an entire study area to a rate-of-return carrier holding company that did not have an existing study area in that state.

price cap carriers.<sup>46</sup> By creating an exception to the rule for the conditional conversion of acquired price cap lines to rate-of-return regulation, we also address this concern and reduce the cost and uncertainty imposed by our rules.<sup>47</sup>

15. We note that the carriers involved in a merger or acquisition must coordinate to ensure that, as of the effective date of the transaction, their respective tariffs reflect the services being offered after the merger or acquisition. We also note that price cap carriers are required to adjust their price cap indices to reflect the removal of the transferred access lines.<sup>48</sup>

## **B. Pricing Flexibility**

### **1. Background**

16. When it adopted the original access charge structure in 1983, the Commission required all incumbent LECs to offer all interstate special and switched access services at geographically averaged rates for each study area.<sup>49</sup> Since that time, the Commission has increased incumbent LECs' pricing flexibility and ability to respond to the advent of competition in the interstate exchange access market. In the *Special Access and Switched Transport Expanded Interconnection Orders*, the Commission introduced a system of density pricing zones that permits a rate-of-return carrier to deaverage geographically its rates for special access and switched transport services, provided that they can demonstrate the presence of "operational" special access and switched transport expanded interconnection arrangements and that there is at least one competitor in the study area.<sup>50</sup> The density zone pricing rules permit rate-of-return

<sup>46</sup> ITTA Comments at 2-3; ICORE Comments at 14-15.

<sup>47</sup> The LECs involved in the transaction would still need to obtain any required study area waiver. Similarly, an average schedule rate-of-return LEC would need to obtain a waiver to operate the acquired lines as part of an average schedule company.

<sup>48</sup> See 47 C.F.R. § 61.45(d); *Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1, First Report and Order, 10 FCC Rcd 8961, 9100-08, paras. 321-334 (1995).

<sup>49</sup> 47 C.F.R. § 69.3(e)(7). A study area is a geographical segment of a carrier's telephone operations. Generally, a study area corresponds to a carrier's entire service territory within a state. Thus, carriers operating in more than one state typically have one study area for each state, and carriers operating in a single state typically have a single study area. Carriers perform jurisdictional separations at the study area level. For jurisdictional separations purposes, the Commission adopted a rule freezing study area boundaries effective November 15, 1984. Part 36 of the Commission's Rules, 47 C.F.R., Part 36, Appendix-Glossary, definition of "Study Area." See MTS and WATS Market Structure, Amendment of Part 67 of the Commission's Rules and Establishment of a Joint Board, CC Docket Nos. 78-72 and 80-286, 49 Fed. Reg. 48325 (Dec. 12, 1984), adopted by the Commission, 50 Fed. Reg. 939 (Jan. 8, 1985).

<sup>50</sup> 47 C.F.R. § 69.123. See also *Expanded Interconnection with Local Telephone Company Facilities, Amendment of the Part 69 Allocation of General Support Facility Costs*, CC Docket Nos. 91-141 and 92-222, Report and Order and Notice of Proposed Rulemaking, 7 FCC Rcd 7369, 7454-56 (1992) (*Special Access Expanded Interconnection Order*). Section 69.123(a) of the Commission's rules allows rate-of-return carriers to establish traffic density pricing zones in study areas in which at least one interconnector has taken a cross-connect. See 47 C.F.R. § 69.123(a). "Expanded interconnection" refers to the interconnection of one carrier's circuits with those of a LEC at one of the LEC's wire centers so that the carrier can provide certain facilities-based access services.

carriers to establish a "reasonable" number of zones, but the Commission has noted in the past that "LECs seeking to establish more than three zones shall be subject to increased scrutiny and must carefully justify the number of zones proposed in their density pricing zone plan."<sup>51</sup> In addition, rate-of-return LECs must show that density zones reflect cost characteristics such as traffic density or other measures of traffic passing through particular central offices.<sup>52</sup>

17. The Commission also permitted incumbent LECs to offer volume and term discounts for switched transport services upon specific competitive showings. Thus, LECs may offer such discounts in a study area upon demonstration of one of the following conditions: (1) 100 DS1-equivalent switched cross-connects<sup>53</sup> are operational in the Zone 1 offices in the study area; or (2) an average of 25 DS1-equivalent switched cross-connects per Zone 1 office are operational. In study areas with no Zone 1 offices, volume and term discounts may be implemented once five DS1-equivalent switched cross-connects are operational in the study area. Rate-of-return carriers are prohibited from offering interstate access services pursuant to individual customer contracts.

18. In 1999, the Commission recognized that the variety of access services available on a competitive basis had increased significantly since the adoption of the price cap rules. The Commission therefore granted price cap carriers immediate flexibility to deaverage services in the trunking basket.<sup>54</sup> The Commission allowed price cap carriers to define the scope and number of zones within a study area, provided that each zone, except the highest-cost zone, accounts for at least 15 percent of the incumbent LEC's trunking basket revenues in the study area and that annual price increases within a zone do not exceed 15 percent.<sup>55</sup> Price cap carriers were also allowed to introduce new services on a streamlined basis.<sup>56</sup>

19. The Commission also adopted a framework for granting further regulatory relief upon satisfaction of certain competitive showings. The Commission determined that relief generally would be granted in two phases and on a Metropolitan Statistical Area (MSA) basis. To obtain Phase I relief, the Commission required price cap carriers to demonstrate that competitors have made irreversible, sunk investments in the facilities needed to provide the

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<sup>51</sup> *Special Access Expanded Interconnection Order*, 7 FCC Rcd at 7454, n.413.

<sup>52</sup> *Id.* at 7455, para. 179.

<sup>53</sup> A cross-connect is the cabling inside the LEC central office that connects the LEC network to the collocated equipment dedicated to a competitive access provider using expanded interconnection.

<sup>54</sup> The Commission also eliminated the requirement that price cap carriers file their zone plans prior to filing a tariff.

<sup>55</sup> 47 C.F.R. § 69.123(b)(1); *Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Interexchange Carrier Purchases of Switched Access Services Offered by Competitive Local Exchange Carriers, and Petition of U S West Communications, Inc. for Forbearance from Regulation as a Dominant Carrier in Phoenix, Arizona MSA*, Fifth Report and Order and Further Notice of Proposed Rulemaking, 14 FCC Rcd 14221, 14254, para. 62 (1999) (*Pricing Flexibility Order*).

<sup>56</sup> 47 C.F.R. § 69.4(g); *Pricing Flexibility Order*, 14 FCC Rcd at 14239-43, paras. 37-44.

services at issue.<sup>57</sup> Phase I relief permits price cap carriers to offer, on one day's notice, volume and term discounts and contract tariffs for these services, so long as the services provided pursuant to contract are removed from price caps. To protect those customers that may lack competitive alternatives, carriers receiving Phase I flexibility are required to maintain their generally available, price cap constrained tariffed rates for these services.

20. To obtain Phase II relief, the Commission required price cap carriers to demonstrate that competitors have established a significant market presence (*i.e.*, that competition for a particular service within the MSA is sufficient to preclude the incumbent from exploiting any individual market power over a sustained period) for provision of the services at issue.<sup>58</sup> Phase II relief permits price cap carriers to file tariffs for these services on one day's notice, free from both the Part 61 rate level and the Part 69 rate structure rules.<sup>59</sup> The Commission eliminated the low-end adjustment mechanism for price cap carriers qualifying for and electing to exercise either Phase I or Phase II pricing flexibility.<sup>60</sup>

21. The Commission has permitted both price cap and rate-of-return carriers to deaverage their subscriber line charges.<sup>61</sup> LECs are also permitted to disaggregate their high-cost loop and ICLS universal service support.<sup>62</sup> We also streamlined the requirements for rate-of-return carriers to introduce new services in the *MAG Order*.<sup>63</sup>

22. Recognizing the importance of pricing flexibility as competition develops in the service areas of rate-of-return carriers, the Commission sought comment in the *MAG Further Notice* on the types, degree, and timing of pricing flexibility that should be made available to rate-of-return carriers in addition to the pricing flexibility already available to them under current rules.<sup>64</sup> The Commission focused on three types of pricing flexibility: geographic deaveraging within a study area; volume and term discounts; and contract pricing.

23. Several parties filed comments on the pricing flexibility issues, representing a variety of customer and industry perspectives. Many of the comments address pricing flexibility and triggers in a very general manner, without differentiating meaningfully among the types of pricing flexibility and a trigger that might be associated with it. Rate-of-return carriers and their trade associations support geographic deaveraging, volume and term discounts, and contract

<sup>57</sup> For the specifics of the triggers required, *see generally Pricing Flexibility Order*, 14 FCC Rcd at 14265-87, paras. 81-121.

<sup>58</sup> For the specifics of the triggers required, *see generally id.* at 14296-302, paras. 141-157.

<sup>59</sup> 47 C.F.R. § 69.709(c); *Pricing Flexibility Order*, 14 FCC Rcd at 14296-302, paras. 141-157.

<sup>60</sup> *Pricing Flexibility Order*, 14 FCC Rcd at 14303-07, paras. 160-167.

<sup>61</sup> 47 C.F.R. § 69.152(q); 47 C.F.R. § 69.104(r).

<sup>62</sup> 47 C.F.R. § 54.315.

<sup>63</sup> *MAG Order*, 16 FCC Rcd at 19698-700, paras. 199-205.

<sup>64</sup> *MAG Further Notice*, 16 FCC Rcd at 19711-17, paras. 241-59.

pricing for rate-of-return carriers to make their pricing structures more efficient.<sup>65</sup> On the other hand, several competitors to rate-of-return carriers oppose any increased pricing flexibility for rate-of-return carriers.<sup>66</sup> Rate-of-return carrier competitors argue that pricing flexibility can be used to erect barriers to entry.<sup>67</sup>

## **2. Discussion**

24. In this Order, we immediately permit rate-of-return carriers to deaverage geographically their rates for transport and special access services and to define both the scope and number of zones, provided that each zone, except the highest-cost zone, accounts for at least 15 percent of its revenues from those services in the study area. Such action will provide rate-of-return carriers greater flexibility to respond to market place conditions, thereby benefiting consumers in rural areas. We retain the existing triggers for when rate-of-return carriers may offer volume and term discounts for transport services to respond to competitive developments. We also continue the prohibition on rate-of-return carriers' ability to offer contract carriage. Finally, we address only the initial timing for the provision of geographic deaveraging of transport and special access services and the provision of volume and term discounts for transport services because the record does not address the timing of the subsequent evolution in pricing flexibility. We also modify the safeguards applicable to rate-of-return carriers that offer geographically deaveraged rates for transport and special access services.

### **a. Geographic Deaveraging of Transport and Special Access Services**

25. In this Order, we amend section 69.123 of the Commission's rules to permit rate-of-return carriers immediately to deaverage geographically their rates for transport and special access services. As the Commission did for price cap carriers, we will permit rate-of-return carriers to define both the scope and number of zones, provided that each zone, except the highest-cost zone, accounts for at least 15 percent of its revenues from those services in the study area. We will require, however, that the zones established for transport and special access deaveraging are consistent with any UNE zones adopted pursuant to the requirements of section 251 and will require rate-of-return carriers to demonstrate that rates reflect cost characteristics associated with the selected zones. Granting rate-of-return carriers more flexibility to deaverage these rates enhances the efficiency of the market for those services by allowing prices to be tailored more easily and accurately to reflect costs and, therefore, facilitates competition in both higher and lower cost areas. This is another step in facilitating the ability of rate-of-return carriers that offer deaveraged UNE rates to establish access and UNE rates that reflect common zone boundaries.

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<sup>65</sup> See, e.g., ALLTEL Comments at 46-47; ICORE Comments at 16; NTCA Comments at 8-9; NRTA Comments at 17.

<sup>66</sup> See, e.g., AT&T Comments at 19-23; CUSC Comments at 7-8; WorldCom Comments at 4.

<sup>67</sup> See, e.g., AT&T Comments at 19-20; GCI Comments at 10-11; WorldCom Comments at 4.

26. Since 1992, the Commission has permitted rate-of-return carriers to deaverage certain rates by geographic zones because of the concern that averaged rates might create a pricing umbrella for competitors that would deprive customers of the benefits of more vigorous competition.<sup>68</sup> Rate-of-return carriers argue that increased pricing flexibility is now necessary for a variety of reasons. They argue that immediate geographic rate deaveraging would increase the efficiency of the interstate rate structure by moving rates closer to actual costs<sup>69</sup> and would offer rate-of-return carriers the flexibility to adjust rates in line with the capabilities of potential competitors.<sup>70</sup> The National Rural Telecom Association, the Organization for the Promotion and Advancement of Small Telecommunications Companies, and the United States Telecom Association (collectively NRTA) assert that geographic deaveraging is no different than SLC deaveraging and universal service disaggregation, which the Commission has already adopted.<sup>71</sup>

27. Our action here, which permits rate-of-return carriers immediately to deaverage the rates for transport and special access services, represents a measured modification of the current rule. That rule permitted rate-of-return carriers to deaverage these rates when a single entrant has established a cross-connect in one central office in the rate-of-return carrier's study area.<sup>72</sup> Thus, rather than filing deaveraged rates only when a competitor has entered the market via collocation, the rate-of-return carrier may now, immediately upon the effective date of this order, file deaveraged rates that may become effective in fifteen days. Competitors that enter the rate-of-return carrier's market through means other than collocation will, of course, be competing against the rate-of-return carrier's deaveraged rates immediately. Deaveraged rate-of-return carrier rates may provide valuable information about the prices the entrant will face when it enters and may thus reduce uneconomic entry that could result from errors in estimating the rate-of-return carrier's pricing response to competitive entry. The greater flexibility afforded by the ability to deaverage transport and special access rates will benefit access customers through more efficient pricing of access services.<sup>73</sup>

28. We are not persuaded by GCI that geographic deaveraging will lead to unreasonable, monopolistic rates in areas not served by a competitor.<sup>74</sup> Thus, deaveraging of

<sup>68</sup> See *Special Access Expanded Interconnection Order*, 7 FCC Rcd at 7454, para. 178; *Expanded Interconnection with Local Telephone Company Facilities, Amendment of Part 36 of the Commission's Rules and Establishment of a Joint Board*, CC Docket Nos. 91-141 and 80-286, Second Report and Order and Third Notice of Proposed Rulemaking, 8 FCC Rcd 737, 7426, para. 98 (1993) (*Switched Transport Expanded Interconnection Order*).

<sup>69</sup> ALLTEL Comments at 47.

<sup>70</sup> NTCA Comments at 9.

<sup>71</sup> NRTA Comments at 19.

<sup>72</sup> 47 C.F.R. § 69.123(c) and (d).

<sup>73</sup> While rate-of-return carriers have not taken full advantage of the geographic deaveraging currently available under our rules, we do not believe this is sufficient grounds for not granting rate-of-return carriers greater flexibility to deaverage transport and special access services. The lack of flexibility in our density zone pricing rules may be responsible for rate-of-return carriers' failure to take full advantage of such opportunities.

<sup>74</sup> See GCI Reply at 3.

transport and special access rates should not permit rate-of-return carriers to erect barriers to entry.<sup>75</sup> Any deaveraged rates will be subject to the tariff review and complaint processes. Continuing to require averaged rates could result in preclusion or uneconomic entry. The Commission has observed that averaging across large geographic areas distorts the operation of markets in high-cost areas because it requires incumbent LECs to offer services in those areas at prices substantially lower than their costs of providing those services.<sup>76</sup> Prices that are below cost reduce the incentives for entry by firms that could provide the services as efficiently, or more efficiently, than the incumbent LEC.<sup>77</sup> Similarly, discrepancies between price and cost may create incentives for carriers to enter low-cost areas even if their cost of providing service is actually higher than that of the incumbent LEC.<sup>78</sup>

29. We also simplify our rules by allowing the rate-of-return carrier to establish its own zones. This is consistent with the Commission's decision in the *Pricing Flexibility Order* that concluded that traffic density is not the optimal, or even an accurate, method of determining cost-based pricing zones and that LEC-designed zones are more likely to lead to efficient pricing that reflects underlying cost characteristics.<sup>79</sup> We therefore conclude that granting rate-of-return carriers the flexibility to choose the number of zones and the criteria for establishing zone boundaries is more likely to result in reasonable and efficient pricing zones than if their flexibility is more constrained. Therefore, we eliminate all competitive prerequisites for the deaveraging of transport and special access rates and permit rate-of-return carriers to define pricing zones as they wish, so long as each zone, except the highest-cost zone, accounts for at least 15 percent of the rate-of-return carrier's transport and special access revenues in the study area. With this requirement, we ensure that any lower rates resulting from deaveraging are enjoyed by a range of customers, rather than being focused on only a few customers in a way that might evade our prohibition on contract pricing by rate-of-return carriers for individual customers. While the seven-zone limit that we adopt – the product of the 15 percent requirement discussed above – likely will not be used by most rate-of-return carriers, we find that three zones, as urged by WorldCom,<sup>80</sup> may not be sufficient to provide rate-of-return carriers with the ability to adjust to any likely variation in cost conditions and ensure that a rate-of-return carrier will be able to harmonize its UNE and access zones.

30. The permissive geographic deaveraging we discuss here applies to rates for all services in the transport and special access categories to which density zone pricing currently

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<sup>75</sup> See Sprint Comments at 5-6.

<sup>76</sup> See *Pricing Flexibility Order*, 14 FCC Rcd at 14253-54, para. 61.

<sup>77</sup> *Id.*

<sup>78</sup> *Id.*

<sup>79</sup> *Pricing Flexibility Order*, 14 FCC Rcd at 14253-54, para. 61.

<sup>80</sup> WorldCom Comments at 2-3; but see Sprint Comments at 5-6 (supporting increasing the number of zones to permit further deaveraging to reflect different costs in different geographic zones).

applies. We require that the same zones be used for all transport and special access elements.<sup>81</sup> We will retain the constraints on annual price increases within zones that are contained in section 69.123(e)(1) of our rules.<sup>82</sup> Although such constraints limit rate-of-return carriers' ability immediately to rebalance rates in a manner that reflects the actual costs of providing the services at issue, we remain concerned with preventing the disruptive effects of rapid and unexpected price increases. We will also retain the requirement that transport and special access services offered between telephone company locations be priced at the rates for the higher zone.<sup>83</sup> We note that, under rate-of-return regulation, deaveraging permits LECs to increase rates in one geographic zone only to the extent that they decrease rates in other geographic zones, because a rate-of-return carrier's rates must be targeted to earn no more than the authorized rate of return. Furthermore, a rate-of-return carrier must provide cost support establishing that the deaveraged rates are cost-based. Thus, we are not persuaded by AT&T's claims that greater geographic deaveraging flexibility will lead to predatory pricing by incumbent LECs or arguments that any further deaveraging should result only in price decreases, *i.e.*, that it be "downward only."<sup>84</sup> We will no longer require rate-of-return carriers to file zone pricing plans in advance of tariff filings. Parties wishing to challenge the reasonableness of rate-of-return carrier zones may do so as part of the tariff review process, or in a formal complaint under section 208 of the Act.<sup>85</sup>

31. Under the present rules governing geographic deaveraging, rate-of-return carriers may not deaverage transport or special access rates until at least one cross-connect is operational in the study area. Thus, a rate-of-return carrier today would have to have established a cross-connect charge before it could offer the allowed services at deaveraged rates. The cross-connect subelement recovers costs associated with the cross-connect cable and associated facilities connecting the equipment owned by or dedicated to the use of the interconnector with the telephone company's equipment and facilities used to provide interstate special or switched access services.<sup>86</sup> We conclude, as urged by GCI, that a rate-of-return carrier wishing to

<sup>81</sup> The Commission previously has imposed this requirement on geographically-deaveraged transport services. See *Switched Transport Expanded Interconnection Order*, 8 FCC Rcd at 7428, para. 104. The requirement also applies to deaveraging by price cap carriers. *Pricing Flexibility Order*, 14 FCC Rcd at 14255, para. 63.

<sup>82</sup> 47 C.F.R. §69.123(e)(1), which provides that:

Telephone companies not subject to price cap regulation may charge a rate for each service in the highest price zone that exceeds the rate for the same service in the lowest priced zone by no more than fifteen percent of the rate for the service in the lowest priced zone during the period from the date that the zones are initially established through the following June 30. The difference between the rates for any such service in the highest price zone and the lowest priced zone in a study area, measured as a percentage of the rate for the service in the lowest priced zone, may increase by no more than an additional fifteen percentage points in each succeeding year, measured from the rate differential in effect on the last day of the preceding tariff year.

<sup>83</sup> 47 C.F.R. §§ 69.123(c)(2) and (d)(2).

<sup>84</sup> See AT&T Comments at 19-20, *but see* Sprint Comments at 5-6 (cost-based geographically deaveraged rates should not permit rate-of-return carriers to erect barriers to entry).

<sup>85</sup> 47 U.S.C. § 208. See NTCA Reply at 9.

<sup>86</sup> 47 C.F.R. § 69.123(a)(1).



geographically deaverage transport or special access rates must establish a cross-connect element providing for interconnection and may not charge collocated providers for entrance facilities or channel terminations when the entrant provides its own transmission facilities.<sup>87</sup> This merely brings forward the requirement that would apply today if a rate-of-return carrier qualified and elected to geographically deaverage rates. A rate-of-return carrier that could assess such a charge for the combined facilities would clearly still possess some degree of market power, and would be attempting to use that power in an anticompetitive manner. Finally, the requirement that rate-of-return carriers must tariff a cross-connect element in order to geographically deaverage rates ensures that transport competitors can interconnect with the rate-of-return carrier's access network, whether or not rate-of-return carriers claim exemption under either section 251(f)(1) or (f)(2). Thus, competition will not be foreclosed if a carrier claims its exemption, as argued by GCI.<sup>88</sup>

**b. Volume and Term Discounts for Transport Services**

32. In this section, we address the question of whether to relax our rules on volume and term discounts for transport services. Under the current rules, rate-of-return carriers are already permitted to offer volume and term discounts for special access services. After a certain number of DS1 equivalent cross-connects are operational in the study area, they may offer such discounts for transport services.<sup>89</sup> After reviewing the record, we conclude that no relaxation of the requirements for offering volume and term discounts for transport services is warranted at the present time.

33. The Commission has long recognized that it should allow incumbent LECs progressively greater pricing flexibility as they face increasing competition.<sup>90</sup> This has been tempered, however, with the understanding that pricing flexibility, if granted prematurely, might enable incumbent LECs to (1) exclude new entrants from their markets, or (2) increase rates to unreasonable levels. As the Commission observed in the *Pricing Flexibility Order*, monopolists have an incentive to reduce prices in the short run and forgo current profits in order to prevent the entry of rivals or to drive them from the market.<sup>91</sup> The monopolist may then raise prices above competitive levels and earn higher profits than would have been possible if the exclusionary pricing behavior had not occurred and competitors had not exited or been deterred

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<sup>87</sup> GCI Comments at 14. We note that, because we retain the cross-connect trigger for the offering of volume and term discounts for transport services, rate-of-return carriers will be subject to a similar requirement in offering volume or term discounts for transport services.

<sup>88</sup> GCI Reply at 23.

<sup>89</sup> 47 C.F.R. § 69.111(j) and (k); 47 C.F.R. §69.112(g) and (h).

<sup>90</sup> The Commission first sought comment on a "road map" for increasing pricing flexibility in response to increased competition in the *Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1, Second Further Notice of Proposed Rulemaking, 11 FCC Rcd 858 (1995).

<sup>91</sup> *Pricing Flexibility Order*, 14 FCC Rcd at 14263, para. 79.

from entering the market.<sup>92</sup> Thus, an incumbent LEC can forestall the entry of potential competitors by "locking up" large customers by offering them volume and term discounts at or below cost. Locking in large customers can foreclose competition for smaller customers as well, because large customers may create the inducement for potential competitors to invest in sunk facilities which, once sunk, can be used to serve adjacent smaller customers.

34. In the *MAG Further Notice*, the Commission sought comment on the appropriate triggers for determining when rate-of-return carriers should be permitted to adopt other forms of pricing flexibility. The Commission noted the risk that rate-of-return carriers could use increased pricing flexibility to engage in exclusionary pricing behavior and thereby thwart the development of competition.<sup>93</sup> This built on the *Pricing Flexibility Order*, in which, as a condition for granting further pricing flexibility in the form of volume and term discounts and contract carriage, price cap carriers were required to show that markets are sufficiently competitive both to warrant pricing flexibility so that price cap carriers may respond to competition and to discourage price cap carriers from either excluding new entrants or setting rates to unreasonable levels.

35. After reviewing the record in the instant proceeding, we conclude that these concerns are equally applicable to rate-of-return carrier pricing flexibility, and we find no basis for expanding the transport volume and term discount pricing flexibility available to rate-of-return carriers at this time. We therefore retain the existing cross-connect-based standards as the trigger for when a rate-of-return carrier may offer volume and term discounts for transport services, rather than adopting any alternative suggested in the record. We note that, to date, no party has taken advantage of the existing ability to offer volume and term discounts for transport services—whether because they cannot meet the threshold, or for some other reason, is not apparent from the record before us.

36. The record indicates that there is limited competition in rate-of-return carrier service areas that would serve to discipline the provision of volume and term discounted transport services offered by rate-of-return carriers. Several parties argue that competition has increased and new technologies will permit increasing numbers of carriers, such as wireless providers, to enter rural areas.<sup>94</sup> We agree, however, with those parties that argue that wireless generally is not a substitute for transport,<sup>95</sup> and thus wireless competition is unlikely to restrain rate-of-return carrier pricing of transport services.

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<sup>92</sup> See, e.g., P. Arena & D. Turner, *Predatory Pricing and Related Practices under Section 2 of the Sherman Act*, 88 HARV. L. REV. 697 (1975); O. Williamson, *Predatory Pricing: A Strategic and Welfare Analysis*, 87 YALE L.J. 284 (1977); J. McGee, *Predatory Pricing Revisited*, 23 J. LAW & ECON. 289 (1980); F.M. SCHERER, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* 468-479 (1990).

<sup>93</sup> *MAG Further Notice*, 16 FCC Rcd at 19715, para. 250.

<sup>94</sup> See, e.g., NRTA Comments at 18-19; TCA Comments at 4-5.

<sup>95</sup> TCA Comments at 4-5; GCI Reply at 5-8.

37. We are also skeptical that cable and satellite providers offer competition for transport services to rate-of-return carriers. These competitors largely bypass the rate-of-return carrier switched access network and thus do not restrain transport prices.<sup>96</sup> To the extent that cable may, in certain instances, provide dedicated transmission offerings that bypass the rate-of-return carrier network, rate-of-return carriers today are allowed to offer volume and term discounts for special access services, which would be the service with which the entrant would be competing.

38. Thus, the competition faced by rate-of-return carriers for transport services is limited<sup>97</sup> and is significantly less than that in price cap carrier service areas. Competition in rate-of-return carrier service areas may develop in a more targeted fashion than that for price cap carriers because of the smaller customer base generally, as well as the lower penetration of multi-line business customers that are attractive initial targets of new entrants.<sup>98</sup> In evaluating various triggers for volume and term discounts for transport services, we therefore have considered the diversity among small and mid-sized carriers, as urged by many rate-of-return carrier interests.<sup>99</sup>

39. We conclude, as urged by several commenters, that further volume and term discount pricing flexibility for transport services should be available only if there is evidence of significant competition. Volume and term discount pricing flexibility must be structured to prevent exclusionary pricing behavior to safeguard the development of competition in rate-of-return carrier service areas.

40. We find that the various alternative triggers suggested in the record fail to address the concern with rate-of-return carriers' ability to erect barriers to entry and engage in price discrimination. Several parties contend that pricing flexibility should be granted based on various market opening commitments.<sup>100</sup> While the market opening events that the commenters identify would facilitate the development of competition, they do not, in and of themselves, indicate that any particular level of competition exists. Therefore, there would be no assurance that rate-of-return carriers could not erect barriers to entry, or engage in unreasonable price discrimination. On the other hand, competition can develop without an entrant with ETC status

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<sup>96</sup> See GCI Reply at 10-11.

<sup>97</sup> See, e.g., AT&T Comments at 19-20; WorldCom Comments at 4; Sprint Comments at 5.

<sup>98</sup> The Joint Board recently released data showing that only 12 percent of access lines were multi-line business lines in rural exchanges, compared to 21 percent in price cap exchanges. Rural Task Force: "The Rural Difference" White Paper 2 at 35.

<sup>99</sup> See, e.g., ITTA Comments at 8.

<sup>100</sup> These include triggers such as the filing of a collocation or interconnection tariff, or the rate-of-return carriers renunciation of the rural exemption under section 251(f)(1), *see generally*, e.g., ITTA Reply at 10. NTCA argues that the Commission should not require the presence of a carrier with ETC status in the serving area, the issuance of a request for proposal (RFP) by a customer in the carrier's serving area, the filing of a tariff offering UNEs, or the receipt of a request for UNEs. NTCA Comments at 10. NTCA also argues that these triggers would not be competitively neutral. *Id.* Other parties argue that pricing flexibility should not be permitted unless UNEs are available in the study area, AT&T Comments at 23, or a rate-of-return carrier has renounced the competition-limiting provisions of section 251(f)(1) and (2). See CUSC Comments at 7-8.

being present because significant competition could exist in part of a rate-of-return carrier's service area before an entrant sought ETC status. The argument that UNEs should be available throughout the service area before pricing flexibility should be granted also fails to address the level of competition that might exist because an entrant might enter without using UNEs. We also decline to adopt an approach modeled on that for price cap carriers because we believe that the diversity among rate-of-return carriers and the markets they serve make those triggers an unreliable predictor of the competitive effects in any of the rate-of-return carriers' markets. We believe the actual competition reflected in a cross-connect standard is a better judge of when volume and term discounts for transport services are appropriate because it indicates that the rate-of-return carrier is facing actual competition for those services. It is also administratively easy to administer.

41. In the *MAG Further Notice*, the Commission sought comment on whether any additional pricing flexibility should be conditioned on rate-of-return carriers being required to establish a ceiling rate for the associated non-discounted access service offering.<sup>101</sup> GCI argues that if the Commission permits downward pricing flexibility, it must ensure that the carrier is not permitted to raise other rates to offset the discounts.<sup>102</sup> ALLTEL Communications, Inc., CenturyTel, Inc., Madison River Communications, LLC., and TDS Telecommunications Corporation (ALLTEL) oppose creating any such limitation on the use of pricing flexibility.<sup>103</sup> We decline to adopt such a pricing restriction here. The existing rules applicable to volume and term discounts by rate-of-return carriers do not constrain pricing in the manner urged by GCI, and we are not modifying those rules in this order. The Commission historically has approached volume and term discount offerings by carriers as being subject to the standard that any discounts must be cost-based.<sup>104</sup> We will not depart from this cost-based approach in the instant case.

42. In the *MAG Further Notice*, the Commission also sought comment on whether the study area should be used to measure competitiveness in determining whether pricing flexibility is warranted for rate-of-return carriers.<sup>105</sup> The majority of parties that addressed this issue agree that the MSA would be inappropriate and support the use of the study area to measure competitive entry.<sup>106</sup> TCA argues for measuring entry at the exchange level, or based on

<sup>101</sup> *MAG Further Notice*, 16 FCC Rcd at 19715, para. 250, citing *ATU Telecommunications Request for Waiver of Sections 69.106(b) and 69.124(b)(1) of the Commission's Rules*, Order, 15 FCC Rcd 20655, 20662, para. 22 (2001). The ATU case involved a waiver of two rules for services that rate-of-return carriers were not authorized to offer at volume and term discounts and was accompanied by a representation that ATU did not intend to raise any rates.

<sup>102</sup> GCI Reply at 19-20.

<sup>103</sup> ALLTEL Comments at 49.

<sup>104</sup> See generally *American Telephone and Telegraph Company Revisions to Tariff F.C.C. No. 259, Wide Area Telecommunications Service (WATS)*, CC Docket No. 80-765, Memorandum Opinion and Order, 84 FCC.2d 158 (1980).

<sup>105</sup> *MAG Further Notice*, 16 FCC Rcd at 19717, paras. 257-58.

<sup>106</sup> See, e.g., GCI Comments at 15-16; AT&T Comments at 21-22.

contiguous exchanges because the study area is too large.<sup>107</sup> We will continue to use the study area to determine when volume and term discount pricing flexibility for transport services is warranted. Even if we were inclined to use an exchange standard, the record before us is inadequate to determine what an appropriate grouping of exchanges would be, given the diversity among rate-of-return carriers.

43. We decline to limit the length of any term contract to three years, as suggested by GCI.<sup>108</sup> AT&T and GCI argue that a rate-of-return carrier may attempt to engage in price discrimination or in practices that might otherwise lock-up certain customers.<sup>109</sup> We will not modify the existing rule, which does not limit eligible rate-of-return carriers ability to enter into term contracts of any length. We believe that customers are in the best position to evaluate their individual communications needs and the potential for competitive alternatives. We therefore believe that customers will not enter into excessively long term contracts if attractive alternatives are likely to be available in a shorter period of time.

44. We conclude that it is appropriate to maintain the current trigger for volume and term discounts for transport services even though we do not impose any limitations on special access volume and term discounts. As we have noted above, entrants may provide interstate services by bypassing the LEC's network, without needing a cross-connect in the rate-of-return carrier's central office. Rate-of-return carriers will, in some cases, be able to respond to these competitive offerings with their special access services. With respect to transport, however, competitive entry is dependant on interconnecting with the rate-of-return carrier's switched network. It is therefore appropriate to maintain the existing cross-connect trigger to ensure that a competitive presence exists before a rate-of-return carrier is allowed to offer volume and term discounts for transport services.

45. Finally, we conclude that the record is inadequate to permit us to reach any conclusions regarding Phase II pricing flexibility, non-dominant treatment of any services, or shortened filing periods for some services.<sup>110</sup> Very few parties commented on these issues, and to the extent they did, the comments were in opposition. They argue that competition is inadequate to justify such relief, asserting that rate-of-return carriers could erect barriers to entry or price discriminatorily without any effective control from competitors in the market.<sup>111</sup> As discussed above, there is limited competition in the provision of access services in rate-of-return carrier service areas today. It is not clear how quickly competition will develop, or the form it will take. As a result, we decline to adopt any rule revisions relating to these aspects of the *MAG Further Notice* on the present limited record.

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<sup>107</sup> TCA Comments at 5.

<sup>108</sup> GCI Comments at 16.

<sup>109</sup> AT&T Comments at 19-20; GCI Comments at 18.

<sup>110</sup> *MAG Further Notice*, 16 FCC Rcd at 19716-17, paras. 256-57, 259.

<sup>111</sup> See, e.g., AT&T Comments at 19-21; GCI Comments at 14-18.

c. Contract Carriage

46. In the *MAG Further Notice*, the Commission sought comment on whether rate-of-return carriers should be given authority to offer services pursuant to individual customer contracts. Today, rate-of-return carriers are prohibited from offering interstate access services pursuant to individual customer contracts.<sup>112</sup> After reviewing the record in this proceeding, we decline to permit rate-of-return carriers to offer contract carriage at this time.

47. Rate-of-return carrier interests generally rely on the same arguments to support contract carriage that they presented for relaxed volume and term discounts for transport services: the improved efficiency of cost-based rates, their reliance on a few large customers in many cases, and the need to address competition.<sup>113</sup> NRTA asserts that contract pricing would permit carriers to tailor services and rates to individual customer demand.<sup>114</sup> On the other hand, AT&T opposes extending contract carriage authority to rate-of-return carriers, arguing that it could be used to erect a barrier to entry in the form of favorable contracts for attractive customers resulting in excessive rates for other customers.<sup>115</sup>

48. After reviewing the record, we decline to permit rate-of-return carriers to engage in contract carriage at the present time. Contract carriage would permit a rate-of-return carrier to combine various elements, or parts of elements, in presenting an offering to a customer. This would present rate-of-return carriers with an opportunity to set non-cost-based prices in order to prevent entrants from providing service to the largest customers in their service areas, thereby precluding further competition for smaller customers in their service areas as well. The principal check on rate-of-return carrier rates is the authorized rate of return the Commission has prescribed. A rate-of-return carrier is permitted to set rates that provide the opportunity to earn this return on the entire portion of their rate base that is assigned to interstate access services. Therefore, any predation on the part of a rate-of-return carrier in its contract offerings could be recovered through higher rates for other customers, absent some check on the rate-of-return carrier's ability to accomplish this result.<sup>116</sup> Because any predatory pricing would restrict entry, there would likely be no competitor to provide an alternative to those customers to whom the rate-of-return carrier was charging higher rates. Rate-of-return carriers have not demonstrated in the record how such behavior can be detected and prevented within the rate-of-return regulatory process. The pooling process would make detection even more difficult.<sup>117</sup> The immediate geographic deaveraging of transport and special access services we extend to rate-of-return carriers today, along with the volume and term pricing already available to rate-of-return

<sup>112</sup> See *Special Access Expanded Interconnection Order*, 7 FCC Rcd at 7457-58, para. 186 (rejecting proposals to permit individual case-based pricing arrangements in response to competitors' offerings).

<sup>113</sup> See, e.g., NTCA Comments at 9; NRTA Comments at 18.

<sup>114</sup> NRTA Comments at 19.

<sup>115</sup> AT&T Comments at 19-20; accord GCI Comments at 12-13, 16; WorldCom Comments at 4.

<sup>116</sup> See AT&T Comments at 19-20.

<sup>117</sup> See GCI Comments at 12.

carriers, provide them with meaningful ways to respond to competition. Therefore, balancing the risks of undetectable anticompetitive behavior against the limited competition that presently exists in rate-of-return carrier service areas that could be considered a substitute for access services, we believe the better course is the conservative one of precluding contract carriage for rate-of-return carriers.

**d. Other Issues**

49. In the *MAG Further Notice*, the Commission sought comment on whether pricing flexibility should be permitted within the NECA pooling process.<sup>118</sup> After reviewing the record, we agree with NECA that the pricing flexibility permitted by this order can be accommodated within the pool by modifying its settlement and rate-setting mechanisms so they apply on a more targeted basis to narrower groups of customers.<sup>119</sup> Our current rules would permit such pooling to occur. We note that many of the rate-of-return carriers most likely to exercise this option—ALLTEL, CenturyTel, ACS of Anchorage, TDS—already file their own traffic-sensitive access tariffs for some or all of their study areas. Therefore, by this decision, smaller rate-of-return carriers may be able to offer pricing flexibility through the NECA traffic-sensitive pool that they would not be able to do if required to do so through their own tariffs.<sup>120</sup> The tariffing costs will increase some for those carriers that elect to offer pricing flexibility, whether done on their own or through NECA. We agree with NECA that the increased administrative burdens on NECA will likely be less than those that would result if we were to require rate-of-return carriers to file their own tariffs proposing flexible pricing arrangements.<sup>121</sup>

50. We decline to require rate-of-return carriers to leave the NECA pool and file their own tariffs in order to offer pricing flexibility. We are not persuaded by the arguments of AT&T and GCI that pooling is inconsistent with pricing flexibility.<sup>122</sup> While pooling involves a degree of averaging and risk sharing that would not exist if carriers filed their own tariffs, this is the case whether pricing flexibility is involved or not. Rate-of-return carriers subject to section 61.38 of our rules must file cost support with their tariffs,<sup>123</sup> and those subject to section 61.39 must be prepared to submit cost support upon request.<sup>124</sup> This supporting material will include a clear delineation of the geographically deaveraged pricing zones. It will also describe the process used to establish rates, whether on an individual carrier basis or through the use of some

<sup>118</sup> *MAG Further Notice*, 16 FCC Rcd at 19716, para. 252.

<sup>119</sup> NECA Comments at 9-10. It notes that it currently offers term discounts for high-capacity, synchronous optical channel services and DSL access services. *Id.* at n.16.

<sup>120</sup> NECA Reply at 4.

<sup>121</sup> *Id.* See also NRTA Comments at 19-20, arguing that small and mid-sized carriers should not have to give up the administrative and other benefits of pooling for the competitive benefits of pricing flexibility.

<sup>122</sup> AT&T Comments at 21-22; GCI Comments at 12.

<sup>123</sup> 47 C.F.R. § 61.38.

<sup>124</sup> 47 C.F.R. § 61.39.

aggregation approach, such as the banding NECA currently uses for some rate elements, along with the actual cost support for the services for which pricing flexibility is being offered. While the cost support may not include individual carrier cost data,<sup>125</sup> the NECA tariff filings offering pricing flexibility will include supporting material associated with the rates in question that the Commission and interested parties may utilize to detect efforts to erect barriers to entry or to establish discriminatory pricing practices. This is also consistent with allowing rate-of-return carriers to offer deaveraged SLCs within the NECA common line pool, as we did in the *MAG Order*.<sup>126</sup> Parties wishing to challenge the reasonableness of NECA's pool rates or rate development procedures may do so as part of the tariff review process, or in a formal complaint under section 208 of the Act.

51. We decline to restrict the availability of pricing flexibility with respect to transport elements that cannot be avoided because of network design configuration, as urged by GCI. GCI notes, for example, that an entrant may not be able to interconnect at a remote switch and must therefore purchase transport from the host switch to the remote switch.<sup>127</sup> Rate-of-return carriers assess tandem-switched transport charges for the use of transmission between the host and remote locations in addition to charges for services between the host switch and the point of interconnection with the IXC.<sup>128</sup> Because of the broader application of the tandem-switched transport rate, we do not find it necessary to introduce the limitation GCI requests. This is consistent with the scope of the present rules governing pricing flexibility for rate-of-return carriers.

52. We decline to revise the standard applicable to volume and term discounts for channel terminations. GCI argues that collocation does not indicate that channel terminations are available and urges that they be subject to the same rules as switched loops.<sup>129</sup> The notice sought comment on additional pricing flexibility for rate-of-return carriers. We will not here restrict pricing flexibility that is already available to those carriers. We note that, for most rate-of-return carriers, DS1 and DS3 capacity services will address most customers' needs, and those services are not services subject to the volume discount provisions.

53. We will not limit the availability of pricing flexibility to rate-of-return carriers participating in an incentive regulation plan, as urged by GCI.<sup>130</sup> GCI asserts that incentive regulation reduces a LEC's ability to engage in cost shifting and other forms of anti-competitive cross-subsidization. It further submits that it is difficult to remove both the cost and the demand from rate-of-return formulas, especially if a LEC participates in the NECA pools.<sup>131</sup> While GCI

<sup>125</sup> AT&T Comments at 21-22; GCI Comments at 12.

<sup>126</sup> *MAG Order*, 16 FCC Rcd at 19641-42, paras. 57-60.

<sup>127</sup> GCI Comments at 15.

<sup>128</sup> *Access Charge Reform Order*, 12 FCC Rcd at 16285, para. 220.

<sup>129</sup> GCI Comments at 15.

<sup>130</sup> *Id.* at 12.

<sup>131</sup> *Id.* at 11-13.



is correct that the price cap mechanism facilitated certain pricing relaxation for price cap carriers, it does not follow that the cost-based standards of rate-of-return regulation cannot be used to accomplish the same ends. Rate-of-return regulation was the basis on which cost-based access rates were established in 1984 when the access charge structure was implemented, and it was the basis for all incumbent LEC tariff review until 1991. The tariff rates will be subject to the tariff review process and parties may also file complaints pursuant to section 208 of the Act.<sup>132</sup>

### C. Consolidation of Long Term Support and Interstate Common Line Support

54. In this section, we adopt the Commission's tentative conclusion in the *MAG Further Notice* that LTS should be merged into the ICLS mechanism.<sup>133</sup> In the *MAG Order*, the Commission retained the existing LTS mechanism solely to provide stability to the NECA common line pool during the transition to a more efficient access charge regime. At this time, we find that merging LTS into the ICLS mechanism will provide administrative simplicity by eliminating a duplicative and obsolete mechanism, without affecting the total support received by rate-of-return carriers or negatively affecting carriers that choose to participate in the NECA pool.

#### 1. Background

55. The LTS mechanism is a legacy of the transition to a competitive interstate long distance market after the breakup of AT&T. In the *1983 Access Charge Order*, the Commission created an access charge regime that included SLCs—monthly flat rate charges assessed on end users to recover a capped portion of interstate common line costs—and CCL charges, which are per-minute charges imposed on IXCs to recover any residual interstate common line costs.<sup>134</sup> The NECA common line pool was developed as a means of permitting LECs to recover their interstate common line revenue requirements while maintaining a nationwide average CCL charge.<sup>135</sup> The nationwide average CCL charge, in turn, permitted IXCs to more easily provide their services at nationwide deaveraged rates.<sup>136</sup> The Commission initially prescribed mandatory

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<sup>132</sup> *Id.*

<sup>133</sup> *MAG Further Notice*, 16 FCC Rcd at 19724-26, paras. 272-76. The Commission tentatively concluded that the merger would occur on July 1, 2003, but in order to provide adequate notice of our action here, we conclude that the merger will occur on July 1, 2004.

<sup>134</sup> *MTS and WATS Market Structure*, CC Docket No. 78-72, Third Report and Order, Phase I, 93 FCC.2d 241, 243-44, paras. 3-5, 279-97, paras. 124-96 (1983) (*1983 Access Charge Order*).

<sup>135</sup> *Id.* at 327-29, paras. 312-18, 333-36, paras. 339-49. Pooling carriers charge rates set by NECA, pool their interstate access revenues, and recover their costs from the pools, including a return on investment. *MAG Order*, 16 FCC Rcd at 19624, para. 20. The Commission concluded that a common tariff and pooling arrangement covering the CCL charge was necessary because LEC-specific CCL rates could generate significant pressures on IXCs to deaverage interstate toll rates. *1983 Access Charge Order*, 93 FCC 2d 241, para. 314.

<sup>136</sup> *1983 Access Charge Order*, 93 FCC 2d at 328, para. 314. Toll rate averaging and rate integration are longstanding Commission policies that Congress codified in the 1996 Act. See 47 U.S.C. § 254(g).

pooling to achieve these goals, but recognized that pooling had some negative effects.<sup>137</sup> In 1987, the Commission eliminated mandatory pooling, but created the LTS mechanism to permit carriers remaining in the pool to maintain their nationwide average CCL charges.<sup>138</sup> The LTS mechanism, as originally designed, required LECs that had left the common line pool to make payments into the pool sufficient for the pool to charge the nationwide average CCL rate of non-pooling carriers.<sup>139</sup>

56. In 1997, the Commission concluded that the existing LTS mechanism was not explicit, portable, and competitively neutral, as required the 1996 Act.<sup>140</sup> The Commission concluded, however, that LTS continued to provide important benefits and should be retained in a modified form.<sup>141</sup> Specifically, the Commission relied on the LTS mechanism's usefulness in reducing disparities among CCL charges imposed by LECs: "LTS payments serve the public interest by reducing the amount of loop cost that high cost [rate-of-return carriers] must recover from IXC's through CCL charges and thereby facilitating interexchange service in high cost areas, consistent with the express goals of section 254."<sup>142</sup> To comply with the Act, the Commission concluded that LTS contributions must be removed from the access rate structure and recovered instead through the universal service fund.<sup>143</sup> The Commission also modified LTS by fixing each carrier's LTS at its 1997 level plus growth based on nationwide average loop costs.<sup>144</sup> As a result of these and other reforms, a nationwide average CCL charge was no longer

<sup>137</sup> See *1983 Access Charge Order*, 93 FCC 2d at 327, para. 312, 328, para. 317. For example, pooling limited LEC flexibility in cost recovery, established economically inefficient cost and price distortions, and reduced incentives for LECs to contain costs. See *MTS and WATS Market Structure Amendment of Part 67 of the Commission's Rules and Establishment of a Joint Board*, CC Docket Nos. 78-72 and 80-286, Report and Order, 2 FCC Rcd 2953, 2956-58 paras. 23, 33 (1987) (*1987 Access Charge Order*). The Commission has also recognized that the pool provides additional benefits to pooling carriers, including the pooling of risk and tariff agency services. See *MAG Order*, 16 FCC Rcd at 19726, para. 276.

<sup>138</sup> *1987 Access Charge Order*, 2 FCC Rcd at 2956-58, paras. 23-26, 32-33.

<sup>139</sup> *Id.*

<sup>140</sup> *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Report and Order, 12 FCC Rcd 8776, 9164-65, para. 756 (1997) (*Universal Service First Report and Order*).

<sup>141</sup> *Id.* at 9165 para. 757.

<sup>142</sup> *Id.*; see *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, *Access Charge Reform*, CC Docket No. 96-262, *Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1, *Transport Rate Structure and Pricing*, CC Docket No. 91-213, *End User Common Line Charge*, CC Docket No. 95-72, *Fourth Order on Reconsideration*, 13 FCC Rcd at 5361-63, paras. 74, 76 (*Universal Service Fourth Order on Reconsideration*).

<sup>143</sup> *Universal Service First Report and Order*, 12 FCC Rcd at 9165-66, paras. 757-59.

<sup>144</sup> *Id.* at 8942, para. 306. Beginning in 2000, the annual growth was based on inflation. See 47 C.F.R. § 54.303(a)(4).

possible, though LTS and the common line pool continued to reduce disparities among CCL charges.<sup>145</sup>

57. In the *Universal Service Fourth Order on Reconsideration*, the Commission declined to eliminate the requirement that carriers participate in the NECA common line pool in order to be eligible for LTS.<sup>146</sup> At that time, several petitioners argued that requiring pool membership as a condition of eligibility for LTS was unnecessary in light of the decision to remove LTS from the access rate structure and would hamper the ability of LTS recipients to pass savings from new efficiency gains on to their customers.<sup>147</sup> The Commission concluded that maintenance of the existing LTS program was warranted to avoid disruption to rate-of-return carriers until it undertook comprehensive access charge and universal service reform for such carriers.<sup>148</sup> In support of this conclusion, the Commission repeated its conclusion in the *Universal Service First Report and Order* that LTS reduced CCL charges and thereby facilitated interexchange service in high cost areas.<sup>149</sup> The Commission also cited its desire not to “undermine the pool’s usefulness in permitting participants to share the risk of substantial cost increases related to the CCL charge by pooling their costs and, thereby, charging an averaged CCL rate close to that charged by other carriers. This operation of the pool, like LTS payments, serves section 254’s goal of facilitating interexchange service in high cost areas.”<sup>150</sup>

58. In the *MAG Order*, the Commission undertook comprehensive access charge and universal service reform for rate-of-return carriers. As noted above, the Commission created a new explicit universal service mechanism, ICLS, to replace implicit support provided by CCL charges.<sup>151</sup> This support mechanism provides each incumbent rate-of-return carrier with its allowable common line revenues to the extent they cannot be recovered through end user charges and, at the present time, LTS.<sup>152</sup> In this respect, ICLS is specifically designed to preserve incumbent rate-of-return carriers’ ability to provide affordable, quality services to rural consumers while allowing carriers to recover their common line revenue requirements through a

<sup>145</sup> In October 1997, the Commission granted a request for waiver by NECA, permitting the NECA pool to charge a CCL rate other than the average CCL rate charged by price cap carriers. *Access Charge Reform*, CC Docket No. 96-262, *Price Cap Performance Review for LECs*, CC Docket No. 94-1, *Transport Rate Structure*, CC Docket No. 91-213, Second Order on Reconsideration and Memorandum Opinion and Order, 12 FCC Rcd 16606, 16334-36, paras. 86-89 (1997). Under the conditions of the waiver, the NECA common line pool was permitted to compute the CCL rate as the per-minute amount necessary to recover the difference between revenues from SLCs, LTS, and special access surcharges and the pool’s common line revenue requirement. *Id.* at 16335-36, para. 89.

<sup>146</sup> *Universal Service Fourth Order on Reconsideration*, 13 FCC Rcd at 5361-63, paras. 74-76.

<sup>147</sup> *Id.* at 5360, para. 69.

<sup>148</sup> *Id.*

<sup>149</sup> *Id.* at 5362, para. 74.

<sup>150</sup> *Id.*

<sup>151</sup> *MAG Order*, 16 FCC Rcd at 19667-69, paras. 128-31.

<sup>152</sup> *Id.* at 19668-69, para. 130, 19673-74, para. 142.

more efficient rate structure.<sup>153</sup> The Commission concluded that ICLS should be available to all rate-of-return carriers that would otherwise have recovered interstate common line revenues through CCL charges, and not limited only to participants in the common line pool.<sup>154</sup>

59. The Commission concluded that its action to eliminate the CCL charge in the *MAG Order* negated the primary reason for LTS's existence.<sup>155</sup> The Commission considered immediately merging LTS into the ICLS mechanism, but concluded that LTS should be retained temporarily in order to ensure the stability of the NECA common line pool during the transition to the new access rate structure.<sup>156</sup> Accordingly, the Commission retained the LTS mechanism and adopted rules providing that carriers leaving the pool and foregoing LTS would be ineligible for increased ICLS to make up for the lost LTS.<sup>157</sup> The Commission also issued a notice seeking comment on its tentative conclusion to merge LTS into ICLS effective July 1, 2003, after the completion of the *MAG Order*'s access charge reforms.<sup>158</sup> The Commission explained that, during the interim, LTS would serve to reduce ICLS amounts for carriers but would not affect the total support levels or revenue recovery for rate-of-return carriers, provided they remained in the pool.<sup>159</sup>

60. In response to the *MAG Further Notice*, the Commission received comments both supporting and opposing its tentative conclusion. AT&T, CUSC, and GCI support the Commission's tentative conclusion.<sup>160</sup> NECA and Western Alliance argue that the merger of LTS into ICLS should be delayed pending "longer-term" analysis of the effects of the *MAG*

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<sup>153</sup> *Id.* at 19667-69, paras. 128-31.

<sup>154</sup> *Id.* at 19672, para. 138.

<sup>155</sup> *Id.* at 19672-73, paras. 139-41, 19724-26, paras. 272-76.

<sup>156</sup> *Id.* at 19672-73, paras. 139-41. The Commission ordered a graduated phase-out of the CCL charge between January 1, 2002, and July 1, 2003, contemporaneous with increases to the residential and single-line business SLC caps. *Id.* at 19644-45, para. 65. This phase-out of the CCL charge prevented a spike in ICLS during the gradual phase-in of increased SLC caps. *Id.*

<sup>157</sup> *Id.* at 19672-73 paras. 139-40.

<sup>158</sup> *Id.* at 19724-26, paras. 139-41. In an order released on June 13, 2002, the Commission amended its rules governing LTS. *Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent LECs and IXC's*, CC Docket No. 00-256, Federal-State Joint Board on Universal Service, CC Docket 96-45, Order and Second Order on Reconsideration in CC Docket No. 00-256, 17 FCC Rcd 11593, 11594-97, paras. 4-10 (rel. June 13, 2002) (*June 2002 MAG Reconsideration Order*). The amended rules capped LTS support for certain carriers that would otherwise exceed their common line revenue requirements due to increased SLC revenues as a result of the *MAG Order* reforms.

<sup>159</sup> *MAG Order*, 16 FCC Rcd at 19672-73, paras. 139-41. Because ICLS is reduced by the amount of LTS that a carrier receives or, for carriers that have left the NECA common line pool, the amount of LTS that they would have received had they remained in the pool, a pooling carrier that currently is eligible for both ICLS and LTS will receive less total support if it chooses to leave the pool. 47 C.F.R. § 54.901(a). Due to caps on other revenue sources, such a carrier likely would not be able to recover the lost universal service support from other sources.

<sup>160</sup> AT&T Comments at 23 n.20; CUSC Comments at 8-9; GCI Comments at 18.

*Order* reforms and other pending proceedings.<sup>161</sup> NTCA contends without elaboration that merging LTS into ICLS will diminish the viability of the common line pool, which provides benefits to small rural carriers that participate in it.<sup>162</sup> NRTA, OPASTCO, and USTA, the other members of MAG, have not adopted an official position on the issue of merging LTS into ICLS.<sup>163</sup>

## 2. Discussion

61. We adopt the Commission's tentative conclusion in the *MAG Order* that LTS should be merged into the ICLS mechanism. First, merging LTS into ICLS would promote administrative simplicity. LTS and ICLS duplicatively provide support directed to the rate-of-return carriers' interstate common line costs.<sup>164</sup> ICLS is narrowly tailored to individual carriers' support requirements under the current interstate access rate structure, acting as the residual source of revenue for rate-of-return carriers and ensuring that they can recover their common line revenue requirements while providing service at an affordable rate. LTS, on the other hand, normally provides each carrier with a fixed level of support grown annually by inflation and may bear little relevance to a particular carrier's support requirements. In most cases, LTS will not be sufficient to ensure that a carrier will recover its common line revenue requirement under the current rate structure.<sup>165</sup> Although LTS effectively served the purposes it was designed to serve, it was not designed to meet the requirements of the rate-of-return access charge rate structure in place after the *MAG Order*. Eliminating LTS will make the interstate access rate structure and universal service mechanisms simpler and more transparent.

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<sup>161</sup> NECA Comments at 10-15; Western Alliance Comments at 10-12; NECA Reply at 8-10.

<sup>162</sup> NTCA Comments at 6; *see also* NTCA Reply at 6-7 (supporting NECA's comments).

<sup>163</sup> *See* Letter from Colin Sandy, Associate Attorney, NECA, to Marlene H. Dortch, Secretary, FCC, dated March 14, 2003, Attachment (memorializing ex parte presentation by NECA, NRTA, NTCA, OPASTCO, and USTA).

<sup>164</sup> We find that Innovative's and CUSC's concerns regarding LTS and ICLS are misplaced. Innovative neither opposes nor supports the Commission's tentative conclusion, but raises concerns, based on language in the *MAG Order*, that a rate-of-return carrier may receive less support under the ICLS mechanism than it had previously received under LTS. Innovative Comments at 5-6. That would only occur, however, if the carrier would otherwise recover higher revenues than permitted by its common line revenue requirement, a situation that has been remedied by the Commission's amendment of the LTS rules in June 2002. *See June 2002 MAG Reconsideration Order*, 17 FCC Rcd at 11596-97, para. 8. CUSC argues that the current coexistence of LTS and ICLS permits rate-of-return carriers to receive double support for the common line. CUSC Comments at 8-9. Although LTS and ICLS perform duplicative functions, the two mechanisms are complementary with respect to the amount of support provided. Because a carrier's ICLS is reduced by any LTS received, the carrier would not recover more combined support than it would receive if ICLS or LTS were the sole sources of support for the interstate common line. *See MAG Order*, 16 FCC Rcd at 19673, para. 141.

<sup>165</sup> In other cases, LTS would have permitted some carriers to earn more than their common line revenue requirements had the Commission not amended its rules to limit support in a manner consistent with the ICLS rules. *See June 2002 MAG Reconsideration Order*, 17 FCC Rcd at 11596-97, para. 8.

62. Moreover, even proponents of retaining LTS acknowledge that the Commission's elimination of the CCL charge obviates LTS's primary historical purpose.<sup>166</sup> As the history of LTS makes plain, the Commission's primary concern in developing and retaining LTS over the years has been to reduce disparities in CCL charges among LECs. In its original incarnation, LTS was specifically designed to guarantee that all carriers would charge a nationwide average CCL charge.<sup>167</sup> When the Commission later amended its LTS rules to comply with the 1996 Act rather than eliminating LTS, the Commission continued to focus solely on the public interest served by LTS in reducing the disparities in CCL charges among rate-of-return carriers (though the mechanism no longer guaranteed the maintenance of a nationwide average CCL rate).<sup>168</sup> Having outlived its primary purpose as of July 1, 2003, when the CCL charge was completely phased out, we conclude that LTS should be discontinued in the interest of administrative simplicity.

63. LTS's secondary role as an incentive for continued participation in the NECA common line pool also is no longer a valid reason to maintain LTS as a discrete support mechanism. LTS is only available to carriers that participate in the common line pool.<sup>169</sup> Removing LTS as an artificial incentive for pool participation will give each carrier the freedom to choose to set rates outside of the NECA pool without sacrificing the universal service support that ensures affordable service for its customers. We recognize that NECA has made great strides in providing common line pool participants with increased flexibility in setting individual end user rates and that it anticipates further innovation in this respect.<sup>170</sup> Carriers will undoubtedly regard such flexibility as a tremendous value in making their determinations whether to continue participating in the pool. Nonetheless, we find that each individual carrier is in the best position to decide whether pool participation promotes its particular best interests. We conclude that the decision whether to participate in the pool should be left to each individual carrier based on the pool's inherent administrative benefits for that carrier without additional regulatory inducements.

64. We do not believe that eliminating LTS as an incentive for pool membership will risk or undermine the important benefits for carriers that elect to remain in the NECA common

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<sup>166</sup> See, e.g., NECA Comments at 13 ("As the FNPRM points out, however, the principal rationale for providing LTS funding to NECA pool participants (*i.e.*, assuring nationwide comparability of NECA pool CCL rates) will no longer apply following elimination of the CCL charge."). No commenter contends that LTS serves any purpose other than encouraging participation in the NECA common line pool. See NECA Comments at 10-15; NTCA Comments at 6; Western Alliance Comments at 10-12; NTCA Reply at 6-7.

<sup>167</sup> 1987 Access Charge Reform Order, 2 FCC Rcd at 2957, para. 33 ("The long term support mechanism allows [pooling] carriers to maintain the nationwide averaged CCL rate that would have existed had the mandatory full common line pool been retained.")

<sup>168</sup> Universal Service First Report and Order, 12 FCC Rcd at 9165, para. 757.

<sup>169</sup> 47 C.F.R. § 54.303.

<sup>170</sup> NECA has introduced rate-banding and plans to allow pooling carriers to disaggregate their SLCs as means for carriers to set their prices competitively, and notes that pooling carriers may file their tariffs separately in any event. NECA Comments at 14.

line pool. We recognize the continued benefits of pooling identified by NECA and other commenters, including the reduction of administrative burdens associated with tariff-filing and protection against the effects of short-term revenue fluctuations.<sup>171</sup> We anticipate that many, if not most, carriers will continue participating in the common line pool because of such benefits. In this regard, we note that the NECA traffic-sensitive pool remains viable despite no comparable regulatory incentive for participation. Based on examination of the record, however, we cannot conclude that the benefits of pooling warrant continued use of universal service support to induce carriers to participate in the pool if they are not otherwise inclined to do so.<sup>172</sup>

65. Moreover, the regulatory concerns which justified the use of LTS to induce pool participation no longer hold. In the past, a non-pooling carrier might not recover its common line revenue requirement if it underprojected its costs or overprojected its demand in developing its access charge tariffs. The NECA common line pool spread that risk among all carriers, reducing the likelihood that any one carrier would suffer a major shortfall in revenue. Eliminating the CCL charge renders irrelevant this primary risk-pooling benefit of the common line pool. While the pool formerly ensured that an individual carrier would not suffer if CCL charge revenues were insufficient to recover its common line revenue requirements, the ICLS mechanism now ensures that no individual carrier will fail to recover its common line revenue requirement.

66. Finally, we note that we have taken a more measured approach by deferring implementation of this change for an additional year beyond that originally proposed by the Commission in the *MAG Further Notice*. The Commission adopted a cautious approach to access charge and universal service reform in the *MAG Order*, in recognition of the unique needs and broad diversity of rate-of-return carriers. The Commission had previously retained LTS pending comprehensive reform to the access rate structure. Absent any specific concern, we conclude that the elimination of the LTS mechanism should not be further deferred.<sup>173</sup>

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<sup>171</sup> See *MAG Order*, 16 FCC Rcd at 19726, para. 276; see also *Regulatory Reform for LECs Subject to Rate of Return Regulation*, CC Docket No. 92-135, Notice of Proposed Rulemaking, 7 FCC Rcd 5023, 5030 (1992); *MTS and WATS Market Structure*, CC Docket No. 78-72, *Amendment of Part 67 of the Commission's Rules and Establishment of a Joint Board*, CC Docket No. 80-286, Memorandum Opinion and Order on Reconsideration, 3 FCC Rcd 4543, 4560 n. 108 and accompanying text (1988).

<sup>172</sup> To the contrary, some commenters supporting the retention of LTS argue that LTS itself does not provide a significant incentive for pool participation. These commenters argue that, for the low-cost carriers most likely to leave the pool, "availability or non-availability of LTS is not likely to be a significant factor in reaching a decision as to whether to exit the pool." NECA Comments at 14; Western Alliance Comments at 11 ("Those carriers having relatively low common line costs are unlikely to be influenced to a significant degree by the availability or non-availability of LTS."); NTCA Reply at 7.

<sup>173</sup> NECA generally asserts that the *MAG Order* carried out "extraordinary changes in universal service support and access charge mechanisms," but offers no specific concerns to justify deferring the merger of LTS into ICLS. NECA Comments at 10-15.

The reformed access rate structure adopted in the *MAG Order* possesses greater inherent stability than the prior rate structure.<sup>174</sup>

67. In order to effectuate this decision, we amend our rules to provide that LTS shall not be provided to any carrier beginning July 1, 2004. We note that overall support will not be reduced because our existing rules will operate to automatically increase ICLS by an amount to match any LTS reduction. For that reason, no further action by the Commission is necessary to implement the merger of LTS into ICLS.

#### IV. SECOND FURTHER NOTICE OF PROPOSED RULEMAKING

##### A. Alternative Regulation and the All-or-Nothing Rule

68. In this further notice of proposed rulemaking, we seek additional comment on incentive regulation and on the all-or-nothing rule. CenturyTel and a group of carriers (ALLTEL, Madison River and TDS) filed separate alternative regulation proposals as *ex parte* filings in response to the 2002 notice.<sup>175</sup> These two proposals each contain a feature that would permit a rate-of-return carrier to elect to move some, but not all, of its study areas to incentive regulation. We therefore will address the remaining all-or-nothing issues not resolved above in conjunction with our evaluation of the two incentive regulation plans before us.

##### 1. Background

###### a. All-or-Nothing Rule

69. Section 61.41 of the Commission's rules sets forth certain requirements governing elective entry into price cap regulation and restricting the ability of price cap carriers to leave price cap regulation. We describe these provisions in Section III.A, *supra*. That section also describes the issues raised in the *MAG Further Notice* concerning the modification or elimination of the all-or-nothing rule and the general tenor of the comments we received in response to the notice.

###### b. Alternative Regulation

70. The traditional regulatory model for incumbent LECs has long been rate-of-return regulation.<sup>176</sup> LECs subject to rate-of-return regulation establish tariff rates targeted to achieve

<sup>174</sup> For example, an individual carrier's common line revenues will no longer be threatened by fluctuating minutes of use or inaccurate cost projections that may result in insufficient CCL charge revenues because each carrier will recover its precise common line revenue requirement from ICLS.

<sup>175</sup> See CenturyTel, Inc., Ex Parte in CC Docket Nos. 96-45, 98-77, 98-166 and 00-256 (filed Dec. 23, 2002); ALLTEL Communications, Inc., Madison River Communications LLC and TDS Telecommunications Corporation, Ex Parte in CC Docket Nos. 96-45, 98-77, 98-166 and 00-256 (filed Jan. 31, 2003); letter from Stephen Kraskin, Esq., counsel for ALLTEL Communications, Inc., Madison River Communications LLC and TDS Telecommunications Corporation, to Marlene H. Dortch, Secretary, FCC, dated May 9, 2003 (Kraskin letter) (amending plan to reflect availability to all rate-of-return carriers rather than just to rural rate-of-return carriers).

<sup>176</sup> See *MAG Order*, 16 FCC Rcd at 19622-24, paras. 16-20.